Protecting Your IRA

A MONTHLY RESOURCE FOR IRA OWNERS

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When is a Rollover Not a Rollover?

The IRS will let you take money from an IRA, hold onto the funds for 60 days, and put it into another IRA without paying any tax or penalty on the transaction. If you don't complete the rollover within the 60-day window, the withdrawal becomes a taxable event. Plus if you haven't reached age 59½, you could face a 10% penalty.[1] Fairly simple rule to follow, right? Well, not exactly, since there are a few lesser-known details that if ignored, could cost some IRA owners or beneficiaries a lot of money.

Investors have been known to run afoul of the "same property" rule, which is within the IRS rollover regulations.[2] This law states that a rollover from one IRA or qualified retirement plan to another IRA can only consist of the same property. For instance, you cannot take a cash payment from a 401(k), buy stocks, and then roll the stocks over to your IRA.

If you did that, the IRS would consider the cash distribution from the 401(k) income subject to taxes at the current ordinary income rate. Plus you might have to pay any applicable penalties. Instead, for the above example, you would have to deposit cash in the IRA in order for the transaction to be classified as a tax-free rollover.

Another potential problem can surface for IRA beneficiaries.

Only spouses can rollover an inherited IRA into their own IRA. But they are not under any obligation to do so.[3] It can be done anytime, which allows flexibility for a survivor.

1 http://www.irs.gov/pub/irs-pdf/p590.pdf, page 21
2 http://www.irs.gov/pub/irs-pdf/p590.pdf, page 22
3 http://www.irs.gov/pub/irs-pdf/p590.pdf, page 17

The surviving spouse can move the funds in two ways:

- Withdraw the deceased's IRA and deposit in her IRA within 60 days or
- Directly move the funds via a trustee-to-trustee transfer

Non-spouse beneficiaries including trusts cannot do IRA rollovers.[3] Therefore, they can't use the 60-day rollover rule. And this is where they can get into trouble.

For example, suppose that your son is your IRA beneficiary. After your death, he decides to rollover the money to his own IRA. So he receives a check from the IRA trustee with the intention of depositing it in his IRA within 60 days. Shortly after getting the money, he receives a Form 1099-R from the IRA trustee notifying him of a taxable distribution. He tries to get the transaction reversed but cannot and is now forced to use 35% of his inheritance to pay the income taxes because of the error. I always recommend investors consult with their own qualified tax and financial advisors prior to making any investment decisions.

For help in transferring or rolling over money from your retirement plan or IRA, check off and send in the enclosed coupon

Roth IRAs—Now Could Be The Time

In 1998 an interesting law was passed—the IRS Restructuring and Reform Act. Some of its impacts have already been felt, but if you are in a higher tax bracket and want to pass IRA assets to your heirs, there is a new provision that went into effect in 2005, and you should know about it.

Many seniors prefer Roth IRAs since any investment growth occurring within these accounts come free of federal income taxes and never have to be distributed while the account owner is alive. Although traditional IRA distributions are generally

taxable to both the original account holder and beneficiaries, any money from Roth accounts pass free of federal income tax to you and your heirs.

However, if your modified adjusted gross income (MAGI) exceeds $100,000 you can't convert your traditional IRA to a Roth IRA. This limit applies across the board to both single and joint/married taxpayers. Prior to 2005, any amounts converted from traditional IRAs were counted against the $100,000 limit. Additionally, any RMD received by the taxpayer from traditional IRAs were also counted against this limit. So, if your income from pensions and investments is $70,000 and the amount in your traditional IRA is $80,000, then you would have to limit your conversion to $30,000 to stay within the MAGI limits. Assuming that you were receiving an additional $40,000 in RMD from another IRA, your income would be $110,000 and you would be ineligible for the conversion in 2004 and all-preceding tax years.

Under the new rule now in effect, however, the conversion amount and RMD are not counted against your MAGI for conversion eligibility purposes, which would allow you to do a full Roth conversion in both cases. As a practical matter, some people may want to spread the conversion over a period of years so that they can better manage the taxes owed on any earnings and pretax contributions. Although you'll have to pay the upfront federal income tax on the entire converted amount, withdrawals from the Roth account are income tax free for yourself and your beneficiaries too.

As a general rule, A Roth account holder must be at least 59 ½ years of age and have held the account for at least 5 years to escape the taxes and penalties associated with early withdrawals, and early withdrawals of earnings from Roth accounts will be subject to ordinary income taxes and a 10% early withdrawal penalty**.** However, early withdrawals are treated as being taken first from your principal contribution. This means that the income and penalty can be avoided as long as your withdrawals did not exceed your principal contributions.

Since deficits are mounting, there is no guarantee this conversion benefit will last, or that tax brackets will stay as low as they are currently. Now could be a good time for some income tax planning to see if a Roth IRA conversion will benefit you. Also, if you are not sure about your RMD or do not understand the possible tax consequences your beneficiaries may face when they receive your IRA, please complete and return the enclosed coupon.

IRAs and Non-Working Spouses

If you are still working, you may be looking for a way to put away money for your stay-at-home spouse. You can contribute up to $4,000 (plus another $1,000 if you're 50+) to an IRA for him or her. There are a few requirements to keep in mind, though:

- One spouse must have earned income, such as wages, a salary, tips, professional fees, or bonuses.
- You must be married and file a joint tax return.
- The IRA contribution (for one or both spouses) can't exceed $4,000 each (plus the catch-up amount) or the total amount of earned income, whichever is less.
- Contributions have to be made by April 15th (for the past year) or the day you file your taxes, whichever is earlier.
- Contributions to traditional IRAs can't be made if your spouse is over 70½ in the year for which you are making the contribution.

Yet if you're over 70½, you may be able to fund an IRA for your spouse. However, two factors can limit the deductibility of contributions:

- Participation by the working spouse in an employer-sponsored retirement plan
- The couple's modified adjusted gross income

Or as long as your income does not exceed the IRS's guidelines, you could put money in your spouse's Roth account regardless of your or your spouse's age. The contributions are not deductible, but the funds would accumulate tax-free for as long as he or she lives. And distributions are tax-free as well.

Please keep in mind that a 10% federal tax penalty may apply to traditional and Roth IRA withdrawals taken prior to age 59½ and a Roth IRA does have a five-year holding requirement.

If you would like to review the investment options for your non-working spouse, please check off and return the enclosed coupon. ◆

Get this Valuable Free Information

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